

BEFORE THE  
FEDERAL COMMUNICATIONS COMMISSION  
WASHINGTON, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of )  
)

Simplification of the Depreciation )  
Prescription Process )  
)  
)

CC Docket No. 92-296

TO THE COMMISSION

REPLY COMMENTS OF  
SOUTHWESTERN BELL TELEPHONE COMPANY

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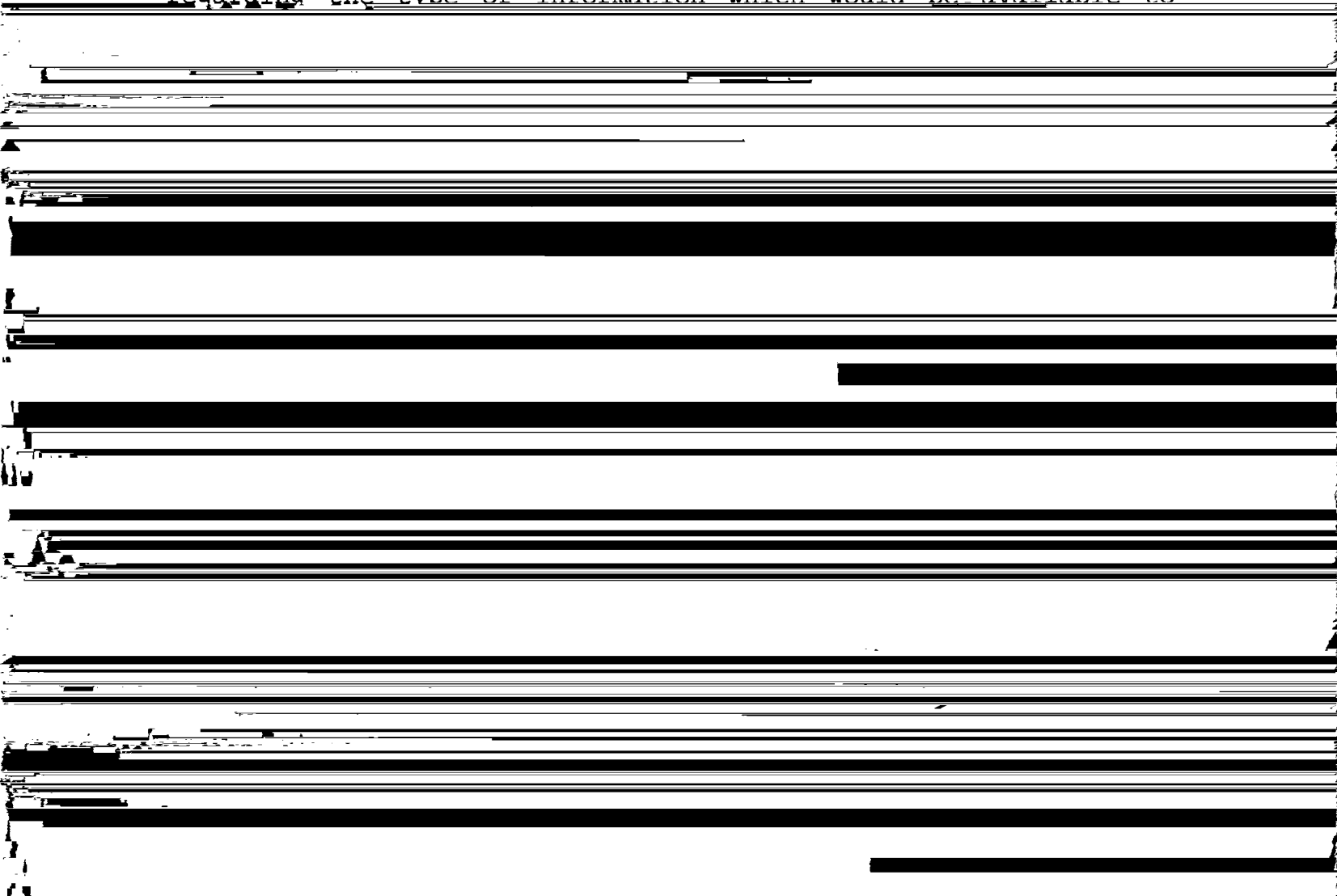
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### SUMMARY\*

Emerging competition in the LEC market requires that the Commission address both simplification and reform of the depreciation prescription process in this proceeding. Only Option IV, the Price Cap Carrier Option works toward the simplification and reform needed in light of the emerging competition.

Option I, the Basic Factor Range Option, proposed by some state regulators simply fails to provide the necessary simplification and reform, especially because of the reliance on existing rates to set the ranges. This proceeding must give full consideration to all options. The concerns expressed by state regulators in opposing Option IV are based on misconceptions regarding the type of information which would be available to



to avoid states exercising their authority to prescribe intrastate rates that deviate from the FCC rate. As SWBT demonstrates, once the misconceptions are corrected, Option IV emerges as the only acceptable alternative.

The era of non-competitive communication services is rapidly dissipating and the industry is currently involved in a swift transition toward a fully competitive environment. Thus, LECs will be facing emergence of competition, which increases the risk of recovery of embedded investment. The Commission needs to initiate the recovery of embedded investment that is currently jeopardized by emerging competition and technological advancements.

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REPLY COMMENTS OF  
SOUTHWESTERN BELL TELEPHONE COMPANY

Southwestern Bell Telephone Company (SWBT), by its attorneys, files this Reply to comments filed in response to the Federal Communication Commission's (Commission) Notice of Proposed Rulemaking (NPRM)<sup>1</sup> for simplification of the depreciation process.

I. INTRODUCTION.

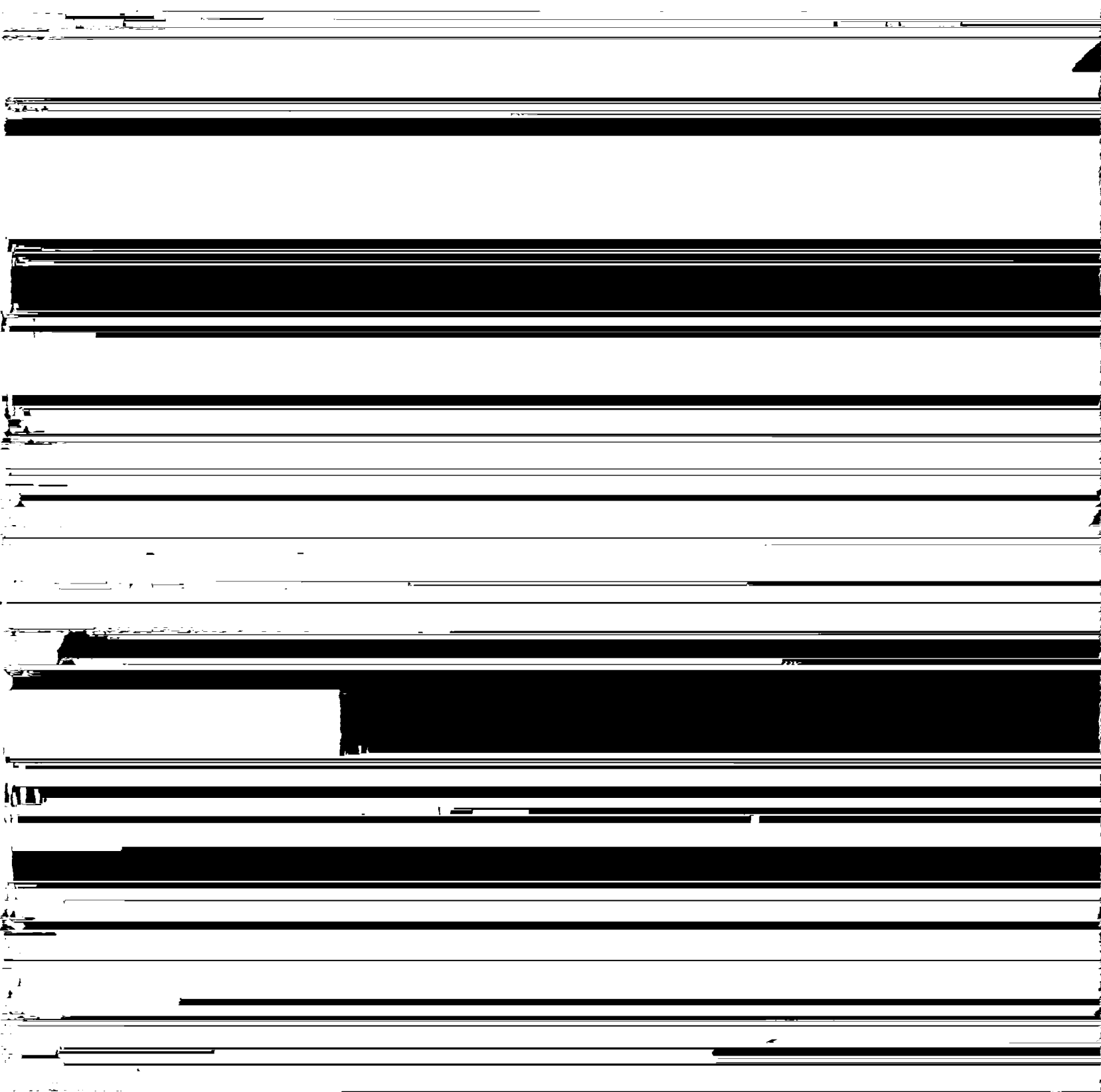
The Commission's stated goal in this proceeding is to reduce unnecessary regulatory burdens and their associated costs through simplification of the depreciation prescription process.<sup>2</sup> To achieve this goal and simultaneously derive a process that will transition into the future, the Commission must not merely simplify the depreciation process, but also develop a framework required for the future. Such reform should provide the ability to transition into a fully competitive environment, while simultaneously spurring aggressive capital investment in the infrastructure.

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<sup>1</sup> In the Matter of Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Notice of Proposed Rulemaking, "NPRM" (Released December 29, 1992).

<sup>2</sup> NPRM at para. 1.

The current depreciation process was developed when there was little competition in the telephone industry and technological advancements were moderately paced. The current depreciation prescription process controls carriers' depreciation expense in a



the ultimate risk.<sup>3</sup> However, regulatory and cost barriers that previously impeded entry of new competitors into the communication industry are eroding at an extraordinary pace. The emerging competition the LECs are facing in the local exchange market is acknowledged by the Commission in this proceeding.<sup>4</sup> The Commission has recognized that with the expanded interconnection ordered in CC Docket No. 91-141 special access competition could develop more rapidly than interexchange competition.<sup>5</sup> The Commission also recognizes that the same could be true for switched transport competition.<sup>6</sup>

The resulting change in the competitive equation is impacting the ability of this Commission and the state regulators to ensure ultimate recovery of deferred capital investment. Therefore, simplification and reform of the depreciation process is essential to provide LECs with the ability to establish

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<sup>3</sup> In the Matter of Amendment of Part 31 (Uniform System of Accounts for Class A and Class B Telephone Companies) So as to Permit Depreciable Property to be Placed in Groups Comprised of Units with Expected Equal Life for Depreciation Under the Straight-Line Method, Docket No. 20188, 83 FCC 2d. 267, 276 (1980) (Docket 21088 Order). In Docket 20188, the Commission recognized that "even when an asset is underdepreciated at the time it is retired, from

depreciation rates reflect the underlying shorter economic lives experienced in a competitive marketplace.<sup>7</sup>

The Commission previously recognized the need for simplification of the depreciation prescription process and responded by granting simplification for minor accounts (Group I Accounts) within the existing process.<sup>8</sup> In the present docket, certain proposals for carriers greater flexibility in choosing depreciation rates, it is apparent that the Commission is attempting to provide greater flexibility to the carriers in developing depreciation rates appropriate in a competitive environment.

State commissions have also recognized shortfalls in the depreciation prescription process, and are beginning to respond. States such as New Jersey, Tennessee, and Connecticut are cooperating with telephone companies by providing accelerated depreciation rates and other regulatory reform to facilitate investment in the telecommunications infrastructure.<sup>10</sup>















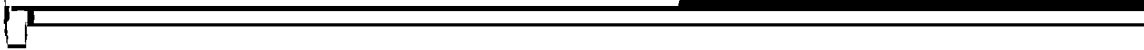
The shortcomings in the current depreciation prescription process should be addressed by the Commission in this proceeding. The Price Cap Cost of Service Option, Option IV, is the appropriate

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<sup>7</sup> CF., AT&T Petition for Waiver of the Commission's Depreciation Method Procedures, AAD 93-18, pp. 8 and 14 (Filed January 27, 1993)



mechanism to achieve simplification of the depreciation prescription process and simultaneously develop the framework essential for future oriented reform. Simplification and reform



IV for LECs.<sup>11</sup> For example, the resolution adopted by NARUC regarding this docket states that the "Price Cap Carrier Option would allow Price Cap Carriers to file depreciation rates with no supporting data."<sup>12</sup>

The NPRM states that affected carriers will provide their current depreciation rates in effect, their proposed depreciation

the Commission, state regulators and all interested parties, would continue to have data available to analyze reserve level trends over time, to make comparisons among carriers and other businesses, and to determine the overall reasonableness of the proposed rates.<sup>17</sup>

LECs have a vested interest in their state commissions agreeing with their proposed rates. Thus, it is reasonable to assume that LECs will continue to work with their state regulators when preparing proposed depreciation rates, including providing any relevant information that is requested by the regulators. LEC incentives to cooperate with state regulators include the obvious problem of a state commission adamantly opposing the filing during the public comment cycle and, more importantly, the fact that a state can exercise its authority to prescribe intrastate rates that deviate from the FCC rate.<sup>18</sup> The LECs are clearly aware of the burdens associated with additional sets of depreciation rates at the state level. Thus, it is reasonable to assume that the LECs will continue to socialize their proposed depreciation rates with the state regulators.

B. The Commission Will Continue to Prescribe Depreciation Rates.

Misconceptions regarding the Commission's role in the depreciation prescription process under Option IV also seem to

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<sup>17</sup> See, USTA Comments, p. 11.

<sup>18</sup> Louisiana Public Service Commission v. Federal Communication Commission, 476 U.S. 335, 106 S. Ct. 1890 (1986).

underlie much of the objection to this option. For example, the NARUC Resolution states that Option IV "should not be adopted" because it leaves "the choice of depreciation rates totally up to the carriers."<sup>19</sup> Likewise, some commentators suggest that Option IV would effectively end meaningful regulation of depreciation rates.<sup>20</sup> In general, these opinions appear to be based on a misconception, as explained above, about the supporting documentation that would be available to the regulators and other intervenors, as well as the Commission's role in prescribing depreciation rates under Option IV. In reality, the Commission's role of reviewing and prescribing depreciation rates does not change under any of the proposed options. The only change is in the methodology used to derive and review the depreciation rate.

The Commission will continue to issue Public Notice of proposed rate revisions in accordance with the procedure currently utilized.<sup>21</sup> Further, state regulators will receive notification of proposed depreciation changes for carriers under their jurisdiction and will be provided the opportunity to submit comments, as prescribed by Section 220 (i) of the Communications Act.<sup>22</sup> Thus,

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<sup>19</sup> NARUC Comments, App. A, NARUC Resolution, p. 2 (emphasis added).

<sup>20</sup> MCI Telecommunications Corporation Comments, p. 9; State Consumer Advocate Comments, pp. 21-27; New York State Department of Public Service Comments, p. 12; Virginia State Corporation Commission Staff (Virginia Corporation Commission) Comments, pp. 2-3.

<sup>21</sup> See, i.e., Public Notice, Comment Invited on Depreciation Rate Prescriptions Proposed for Domestic Telephone Carriers, 7 FCC Rcd. 5264 (1992).

<sup>22</sup> 47 U.S.C. 220(i).

state regulators will continue to play an important role in the review process, as LECs have a vested interest in obtaining state regulatory support for their rates.<sup>23</sup> In addition, the public notice and comment cycle provides a forum for intervenors, including competitors, to challenge the LECs' proposed depreciation rates. Thus, all proposed changes in depreciation rates will be subject to intense and vigorous review because state regulators, competitors, and IXCs will not allow depreciation rates to be prescribed in an arbitrary manner.

Further, there is no reason to assume, as insinuated by some commentators,<sup>24</sup> that if Option IV were implemented, the Commission would abdicate its statutory authority by adopting a "rubber-stamping" mentality regarding its duty to review relevant input and prescribe depreciation rates. Rather, it is reasonable to assume that "the Commission would assess the various filings made in response to the Public Notice, consider the views and recommendations of the State Commissions that respond under Section 220 (i), and then evaluate the reasonableness of the carrier's proposals in light of these filings".<sup>25</sup> The Commission has the authority to request additional information, if it is concerned that a carrier's proposed rates do not appear reasonable.<sup>26</sup>

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<sup>23</sup> See, Section II.A p. 7, supra.

<sup>24</sup> Indiana Utility Regulatory Commission, p. 7; Idaho Public Service Commission Comments, pp. 5-6; Public Service Commission of Wisconsin Comments, pp. 7-8; California Cable Television Association (CCTA) Comments, pp. 23-25.

<sup>25</sup> See, USTA Comments, p. 11.

<sup>26</sup> See, Ameritech Operating Companies Comments, p. 7.

Advise the state regulators and request additional information

procedures and reducing associated costs within the depreciation prescription process.<sup>30</sup> The Commission has already granted simplification for minor accounts (Group I Accounts) in the existing process.<sup>31</sup> Therefore, implementation of new procedures that are limited to "minor accounts," would be redundant and an inefficient use of the Commission's limited time and resources.

The exclusion of "major accounts" from the simplification process would similarly deter the Commission's attempt to streamline the depreciation prescription procedures. Specifically, the exclusion of "major accounts" implies status quo in that regulators and LECs will continue the current detailed study and review process for these accounts. It further implies that a variety of methods will be utilized in place of a single process, which will unduly complicate the depreciation prescription process<sup>32</sup> and impede the very essence of simplification. The Commission acknowledged this fact and stated that applying a single option (range) to all accounts, currently subject to prescription of depreciation rates, would result in greater simplification and administrative cost savings.<sup>33</sup>

The PUC of Texas noted in their comments, that the "major" categories of investment have historically displayed

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<sup>30</sup> NPRM at para. 1.

<sup>31</sup> See, fn. 8 supra; See also, PUC of Texas Comments, p. 2.

<sup>32</sup> See, BellSouth Comments, p. 35.

<sup>33</sup> NPRM at para. 16.

variations in factors or parameters.<sup>34</sup> Further, they implied that these variations are created due to differences in retirement patterns deployed by carriers in response to changes in technology, competition, and regulatory policies.<sup>35</sup> Thus, the PUC of Texas recognizes that changes occurring in the market place are directly affecting LECs' managerial decisions. However, they fail to reach the appropriate conclusion therein, that it is these very changes in the market place that require a single prescription process that is applicable to all accounts and at the same time provides the simplification and flexibility required to respond in the competitive market place. To achieve this, LECs must be granted the latitude to establish depreciation rates that ensure the ultimate recovery of shareholders investments given today's market conditions that are materially shortening the economic service lives of assets.

D. Simplification Goals Are Not Limited to Administrative Cost Savings.

The Colorado Public Utilities Commission states that the administrative cost savings envisioned by the FCC will not be significant.<sup>36</sup> ~~CWPB disagrees with this position and notes that~~



the Commission's stated goal is to reduce unnecessary regulatory burdens (i.e., for both carriers and regulators) and their associated expense.<sup>37</sup> The elimination of any unnecessary regulated expense will be beneficial to all parties.

The California Cable Television Association acknowledges that the depreciation prescription process consumes valuable resources (i.e., is expensive and time consuming).<sup>38</sup> While SWBT agrees that the costs of regulation, and the costs of complying with the prescription procedures are significant, this is not the sole motivation of simplification. The Commission states in the NPRM that this rulemaking proceeding was established to determine "in the light of market and regulatory changes" (i.e., emerging competition in the local exchange market, rapidly changing technology, and Price Cap Carrier Regulation), whether the detailed depreciation analysis and prescription process is necessary.<sup>39</sup> Thus, the purpose of simplification is not only associated with cost savings, but also with the need to derive a process that is responsive to changes in the market place,<sup>40</sup> while maintaining cogency with current and future regulatory changes. The

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<sup>37</sup> NPRM at para. 1.

<sup>38</sup> CCTA Comments, p. 27.

<sup>39</sup> NPRM at para. 8.

<sup>40</sup> For example, as Ameritech notes "[T]he interexchange carriers use the same equipment as the LECs, i.e., digital switches, copper cable, and fiber optics. There is no sound logical or economic reason-given the competition the LECs are confronting in the telecommunications industry-to conclude that the investment of interexchange carriers could have substantially different depreciation rates than similar investment by LECs." Ameritech Operating Companies Comments, pp. 10-11.

appropriate simplification method to accomplish this goal is Option IV, because it is the only method that incorporates the latitude and flexibility required to respond in a competitive environment. Further, it is the only option that places the primary responsibility for developing capital recovery proposals on affected carriers where it rightfully belongs.

E. Speculation That the Sharing Mechanism Will Impact Depreciation Decisions Is Unwarranted.

As the Commission notes in the NPRM, under Price Cap Regulation, LECs must share earnings with their customers if earnings fall within a prescribed sharing zone.<sup>41</sup> A few commentators, wishing to keep the LECs confined by burdensome and unnecessary regulation, argue that Option IV should not be adopted because of speculation that the LECs might manipulate depreciation rates to defer sharing.<sup>42</sup> Some state regulators express similar concerns.<sup>43</sup> These concerns and arguments are unwarranted because they ignore the Commission's role in reviewing and prescribing depreciation rates.<sup>44</sup> Further, as noted by several commentators, it ignores the existence of Generally Accepted Accounting Principles (GAAP), Securities and Exchange Commission (SEC) guidelines,

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<sup>41</sup> NPRM at para. 42.

<sup>42</sup> MCI Comments, p. 7; California Cable Television Association Comments, pp. 22-23.

<sup>43</sup> Colorado PUC Comments, p. 26; NARUC Comments, pp. 11-13.

<sup>44</sup> See, pp. 7-10, supra.

internal and external audits, the realities of the financial market and sound business judgment.<sup>45</sup>

The Commission's role in reviewing and prescribing depreciation rates precludes any carrier's ability to "manipulate" depreciation expense to avoid sharing under price cap regulations. Carriers seeking depreciation rate changes must adhere to the Commission's disclosure requirements,<sup>46</sup> and, as previously noted,<sup>47</sup> would file the major data elements used to calculate the depreciation rates. The level of information that will be provided makes it impossible that a substantial change in the level of depreciation expense would go unnoticed, especially since the change in depreciation expense must be provided to the Commission.<sup>48</sup> Further, the public notice and comment cycle provides intervenors, including competitors, the ability to comment (i.e., including speculation regarding rate manipulation) on proposed rates. Thus, it is reasonable to assume that proposed depreciation rates will receive sufficient review required to alleviate concerns regarding manipulation.

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<sup>45</sup> See, SWBT Comments, pp. 12-16; Southern New England Telephone Company (SNET) Comments, pp. 8-12; Bell Atlantic Comments, pp. 8-9; Pacific Bell and Nevada Bell Comments, pp. 12-13; BellSouth Comments, pp. 25-33.

<sup>46</sup> NPRM at para. 41.

<sup>47</sup> See, pp. 6-7, *supra*.

<sup>48</sup> See, Ernst & Young, A Report to the United States Telephone Association, Depreciation Safeguards under GAAP, p. 15. (Ernst & Young Report).

GAAP also operates to constrain carriers' ability to manipulate depreciation expense.<sup>49</sup> GAAP specifically provides that "depreciation be determined in a manner that systematically and rationally allocates the cost of an asset over its useful life."<sup>50</sup> Further, the total depreciation expense for an asset, over its useful life cannot exceed the asset's cost less salvage value<sup>51</sup> (i.e., regulated carriers also must consider cost of removal in the salvage value). Thus, GAAP imposes constraints on the depreciable base, depreciation lives and depreciation methods that can be utilized by carriers.<sup>52</sup>

The SEC is an additional safeguard which would deter ~~potential manipulation of depreciation expense to achieve earnings~~

consequences to the individual and the company.<sup>54</sup> Clearly these are strong deterrents to fraudulent financial reporting, including the potential manipulation of depreciation expense to achieve earnings goals.<sup>55</sup>

The internal and external audit functions are also important safeguards that are utilized to ensure the accuracy of the financial statements and compliance with GAAP. These functions serve as additional checks and balances to provide assurances that the company has a adequate system of internal control, and that the employees are complying with these policies and procedures.

Several commentators also noted that carriers have strong incentives based upon the realities of the financial market and sound business judgement to comply with accounting principles to depreciate investments over appropriate useful lives.<sup>56</sup> As noted by Bell Atlantic, manipulation of depreciation rates to avoid sharing (i.e., increasing depreciation expense and consequently lowering reported earnings) will negatively impact the financial communities' opinion of the carrier.<sup>57</sup> This would ultimately impact the carriers stock price and therein the ability to raise capital.

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<sup>54</sup> Ernst & Young Report, pp. 2 and 27; consequences include: termination of employment, lawsuits against the individual(s) or corporations, fines, and imprisonment.

<sup>55</sup> Ernst & Young Report, p. 27.

<sup>56</sup> SWBT Comments, pp. 14-15; Bell Atlantic Comments, pp. 8-9; SNET Comments pp. 9-10.

<sup>57</sup> Bell Atlantic Comments, pp. 8-9.

Speculation about manipulation of rates to avoid sharing is also unwarranted because it ignores the timing factor involved.

It is unlikely that most carriers would be able to determine that

prescription to prescription.<sup>59</sup> Thus, the Commission notes that if Option I were accepted they believe that the level of simplification and administrative cost savings might have to be sacrificed in order to gain some experience with setting ranges for all accounts.<sup>60</sup> In addition, the updating of the ranges would require the carriers to analyze accounting data and company plans as they do now and to submit such information to the Commission for review.<sup>61</sup> Thus, as noted by SWBT and others, the amount of simplification arising out of Option I is questionable, especially in light of the minimal, if any, impact it will have as a means of

The emerging competition the LECs are facing necessitates that they be given the flexibility to set rates in a manner similar to their competitors. Option I should not be adopted because it fails to provide the desired simplification and reform.

IV. RECOVERY OF EMBEDDED PLANT IS JEOPARDIZED BY EMERGING COMPETITION AND TECHNOLOGICAL ADVANCES.

A few comments state that the Commission must deal with pricing reserve deficiencies.<sup>65</sup> The current depreciation



technological obsolescence make proper capital recovery extremely difficult, and important.<sup>66</sup>

As recently noted by Commissioner Barrett, the communications industry is undergoing rapid changes; technological advancements are hastening the demise of traditional market segments and barriers.<sup>67</sup> Metropolitan Fiber Systems presented further credence to this position by indicating that their networks are technically capable of providing local exchange services and that the principal remaining barriers to providing such services are regulatory and quasi-regulatory, not technological.<sup>68</sup>

Recently, the Commission has initiated several actions that will foster increased competition and have enormous implications on the competitive equation and regulatory framework for the future local exchange markets.<sup>69</sup> These actions include: a mandate of expanded interconnection for special access competitors, proposal to mandate expanded interconnection for switched access competitors, the restructure of transport rates to allow LEC rates to be more competitive, the ONA initiative to

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<sup>66</sup> See, BellSouth Comments, p. 14.

<sup>67</sup> Commissioner Barrett's February 2, 1993 Presentation at the Institute for International Research in Dallas, Texas.

<sup>68</sup> Amendment of the Commission's Substantive Rules to Promote Competition in Local Telephone Services, Petition for Rulemaking, Metropolitan Fiber Systems of Dallas, Inc. and Metropolitan Fiber Systems of Houston, Inc., filed with the Public Utility Commission of Texas, January 6, 1993, pp. 5-6.

<sup>69</sup> Commissioner Barrett's February 2, 1993 Presentation at the Institute for International Research in Dallas, Texas.